

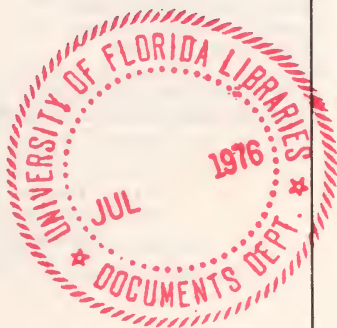
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THE BUDGET AND THE ECONOMY:
THE OUTLOOK FOR CALENDAR YEARS
1976 AND 1977

REPORT
OF THE
TASK FORCE ON ECONOMIC PROJECTIONS
TO THE
COMMITTEE ON THE BUDGET
U.S. HOUSE OF REPRESENTATIVES



MARCH 24, 1976



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(II)

LETTERS OF TRANSMITTAL

MARCH 24, 1976.

To the members of the Budget Committee:

Transmitted herewith is a paper prepared for the Task Force on Economic Projections by the Committee staff entitled "The Budget and the Economy: The Outlook for 1976 and 1977" (DISC).

The paper is being distributed at the request of the Task Force on Tax Expenditures for discussion purposes. It has not been approved by the Committee, nor does it necessarily represent the views of all members of the task force.

Sincerely yours,

BROCK ADAMS, *Chairman.*

MARCH 24, 1976.

HON. BROCK ADAMS,
*Chairman, Committee on the Budget,
U.S. House of Representatives, Washington, D.C.*

DEAR MR. CHAIRMAN: Transmitted herewith is a study prepared by the staff of the House Budget Committee for the Task Force on Economic Projections entitled "The Budget and the Economy: The Outlook for 1976 and 1977."

While the members of the task force do not necessarily agree with all of the points made in the paper, and it has not been approved by the Committee, we recommend its publication as a Committee print in order to stimulate discussion and solicit reactions to it by members of the Committee, and other interested parties.

Sincerely,

THOMAS L. ASHLEY,
Chairman, Task Force on Economic Projections.



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FOREWORD BY HON. THOMAS L. ASHLEY

Lincoln's hundred-year-old judgment that, "If we could first know where we are and whither we are tending, we could better plan what to do and how to do it," is as thoughtful a summary of the problems of budget making as it is of statecraft. The current status of the United States economy and the way it is tending can be summarized as follows:

UNEMPLOYMENT

The recession has driven the economy to such low levels that full employment lies beyond the horizon of most economic forecasts. Even a 5 percent unemployment rate may not be achieved until 1980 or 1981, and the 1976 average will probably be between 7.2 and 7.6 percent.

INFLATION

The general rate of price increases has fallen during the year, averaging 9.1 percent in 1975. During 1976 inflation is expected to continue its downward path but is predicted to continue in the 6 to 7 percent range.

REAL ECONOMIC GROWTH

Although most forecasts predict substantial economic growth during 1976 (5.5 to 6.5 percent), the rate of growth may weaken by the end of the year opening up the prospect that 1977 may be a period of stagnation.

Before we can decide how big a budget and what kind of programs are likely to fit the needs of FY 1977 and beyond, we must have more complete measures of how far recovery has come and how far present programs and policies will go. This report provides a measure of that information.

I. ORIGINS OF THE RECESSION

The United States has rarely experienced a combination of continued high inflation and severe recession. The rising path of inflation during recent years has been a major cause of recession. Inflation dampens purchasing power and the demand for goods and services. It shifts real income from one group to another causing additional price pressures as groups attempt to recoup lost purchasing power. The origin of the 1970's inflation can be traced to four major sources:

A simultaneous worldwide economic boom that led to shortages of raw materials, bottlenecks in production, hoarding, and speculation at home and abroad;

Devaluation of the dollar which made American goods cheaper in world markets and, therefore, increased demand;

Widespread crop failures abroad at a time when stored supplies of agricultural commodities at home were virtually non-existent; and

The OPEC oil embargo and subsequent quadrupling of imported oil prices.

The years 1971 through 1973 were a time of unusually rapid economic expansion in Europe, North America, and Japan. Previous expansions and contractions in economic activity had not occurred simultaneously throughout the developed countries. Devaluation of the dollar in 1971 and 1973 followed by the establishment of freely floating exchange rates in March 1973 were responsible for the worldwide boom in demand for American goods. Serious shortages developed in raw materials with rising wholesale prices even before the explosion in petroleum and agricultural prices. These rising price levels triggered another destabilizing phenomenon, namely the building up of inventories in anticipation of future price increases.

Crop failures in Russia and Africa in 1973 and the disappearance of the anchovies (used for animal feed) in 1971 and 1972 off the coast of South America put severe pressures on domestic food prices. Wholesale prices for farm products rose 41.0 percent at a seasonally adjusted annual rate in 1973. Consumer prices for food rose by 14.4 percent between 1972 and 1973. Although the real output (that is, adjusted for prices) of the agricultural sector was 3.3 percent of GNP in 1972 through 1974, the current dollar output rose from 3 percent of GNP in 1972, to 4.4 percent in 1973, and then, dropped back to 3.8 percent in 1974. Thus 0.8 percent of income was shifted to food producers.

The sharp escalation of food prices was followed by the OPEC oil embargo in October 1973. Since the embargo, OPEC nations have succeeded in raising the price they charge for their oil from approximately \$2.00 per barrel prior to October 1973, to over \$7.00 in early 1974, to about \$10.40 in early 1975 and to nearly \$11.50 presently. In the United States, the prices for "new" oil followed the price of OPEC oil upward and were further increased by the Presidential imposition

of a \$2 per barrel import fee (recently terminated with the signing of the Energy Policy and Conservation Act).

The long-run economic losses resulting from energy price increases are equivalent to 1.3 percent of our Gross National Product. The use of petroleum products in the United States economy is pervasive. We use it to grow our crops, heat our homes, generate a large portion of our electricity, fuel our transportation, manufacture our goods, and produce many synthetic materials. The impact of increases in petroleum prices was more severe in terms of a reduction in real consumer income than the increase in food prices. When the shift in income from the increase in food prices is combined with the shift due to increased oil prices, a total of 2.2 percent of the gross national income was transferred from businesses and consumers to specialized groups.

The severe shocks inflicted on the economy from the inflationary pressure of food and fuel are not likely to be repeated in the near future. The problem that now confronts us is the major redistributive effect on income. To quote from the testimony of Dr. David L. Grove of IBM before our Committee:

The process of establishing a new and tolerably acceptable pattern of income relationships works in two directions. One is that a succession of wage and price, or price and wage, increases is set in motion. The other is that alarm about the mounting inflation causes the Federal government to apply the brakes, through restrictive monetary and fiscal policy. The deterioration of economic growth and of employment opportunities, along, perhaps, with exhaustion from the struggle, gradually forces some of the labor and business groups to recognize that they must settle for less than they have been seeking and feel entitled to get. This process can be a drawn out one. That is why the current inflation still will take some further time to wind down, and why inflation will remain relatively high in the months ahead. It takes an awfully large dosage of recession medicine to produce a moderate slowdown in inflation if the initial inflationary shocks are sharp and extensive, as they certainly were in 1973 and 1974.

The inflation itself produced another depressant on real income. As dollar incomes moved up, families were pushed into higher tax brackets in the personal income tax system. Tax payments rose and real take home pay declined further. Instead of real per capita disposable income (adjusted for prices) rising by 1.9 percent (the post WWII average), it declined between 1973 and 1974 from \$4,068 to \$3,981 or 2.2 percent. Real per capita disposable income increased 0.7 percent in 1975, reflecting the cut in individual income taxes and a slowing in the rate of inflation.

The sharp reduction in real purchasing power became more clearly evident when the new 1975 models of American automobiles failed to move off the showroom floors. In spite of slow sales, the automobile companies continued to produce at close to capacity well into November 1974, at which point the automobile companies began laying off employees and, in some cases, closing plants. Other industries quickly followed. Production slowed even further as businesses attempted to reduce inventories.

Although the pace of economic activity slowed after the imposition of the oil embargo in 1973, the sharp drop in output and employment did not occur for almost a year. The slowdown in the late winter and spring of 1974 was widely viewed as a pause in economic activity until the embargo was lifted and the economy adjusted to the higher oil prices. The decline in real consumer demand was partially masked by

rising prices. In fact the rate of inflation began to accelerate rapidly as the oil price increases spread through the economy.

In addition, private credit began to expand rapidly again even though the level of real economic activity continued to decline as businesses borrowed to increase their inventories in anticipation of inflation. Escalating inflation and increases in the money supply associated with the extraordinary private demand for credit posed a serious problem for the monetary authorities. Although the money supply was permitted to rise at a rate of $5\frac{1}{2}$ to $6\frac{1}{2}$ percent from early 1973 to mid-1974, prices were rising at an even faster rate. In effect, therefore, monetary policy worked to reduce the level of real money balances during this period. Moreover, as the inflation continued at double digit rates during the latter half of 1974, the Fed cut back the growth of the money supply, thus reducing real money levels even further. There can be little doubt that the economic result of that policy was to worsen significantly the oncoming recession.

The high interest rates of 1973 and 1974 had the usual depressant effect on the housing industry. As market interest rates rose, funds flowed from the major sources of mortgage financing (savings and loan associations) into short-term marketable securities. With the disappearance of mortgage funds and the rise in mortgage interest rates, housing starts declined, reaching a post WWII low of 880,000 units at an annual rate in December 1974.

II. CONGRESSIONAL ACTION TO STOP THE RECESSION

Public finance texts have described the Federal Budget as a means of allocating resources, redistributing income, and providing economic stability.¹ Resources are allocated between public and private uses and within the public sector by further division among health, housing, defense, and other interests. Income redistribution is accomplished by deciding who will pay how much in taxes and who shall receive social security or welfare benefits. In recent years, the Federal Budget has been increasingly used to promote economic stabilization. The aim has been to promote economic growth without inflation. Congressional actions during 1975 were dominated by these economic stabilization considerations, and the 1975 tax decisions reflect this fact.

TAX REDUCTION

The adaptation of the tax system to fit changing economic circumstances has become increasingly important since tax reduction was first used as a counter-cyclical tool in 1964. As the recession worsened, the President's proposal made during the fall of 1974 for a 5 percent surcharge to fight inflation was not acted upon. Instead, the 1975 Tax Reduction Act lowered calendar year 1975 liabilities by nearly \$13 billion and refunded \$8 billion of the 1974 tax liability. The effect of the tax change was to restore real consumer purchasing power and increase consumer demand. The major provisions of the Act for individuals were:

A one-time tax rebate equal to 10 percent of calendar year 1974 tax liabilities subject to minimum and maximum rebates of \$100 and \$200 respectively. Most of the rebate checks were sent out in May and June 1975.

A \$30 tax credit per personal exemption (except the special exemptions for the blind and aged);

An increase in the low income allowance (minimum standard deduction) from \$1,300 per return to \$1,900 for a joint return or \$1,600 for a single person;

An increase in the percentage standard deduction from 15 percent of adjusted gross income (AGI) with a maximum of \$2,000 to 16 percent of AGI with a maximum of \$2,600 for a joint return or \$2,300 for a single person;

An earned income credit for families with dependent children equal to 10 percent of earned income subject to a maximum of \$400. The maximum credit is phased down to zero between AGI or earned income, whichever is greater, of \$4,000 and \$8,000; and

¹ A substantial body of legislation enacted during the last forty years serves to promote several of these functions. Unemployment insurance, welfare assistance, the food stamp program and veterans assistance all have a strongly redistributive character. They also act as economic stabilizers expanding rapidly as recession begins *without* the necessity of Congressional action and declining as prosperity returns.

A 5 percent credit, with a maximum of \$2,000, on the price of a new home acquired after March 12, 1975, and before January 1, 1976, provided that construction began prior to March 26, 1975.

Most of the tax reductions applied to all of calendar year 1975. However, since the Act did not become law until the end of March, the change in withholding schedules to reflect the reduction did not begin until May 1, 1975. Withholding rates were then reduced to reflect the full year's tax reduction; these withholding rate reductions were, therefore, greater than would have been necessary if such reductions had begun on January 1, 1975.

The major provisions affecting corporation income tax liabilities were:

An increase in the investment credit—applicable to equipment acquired and put in service in calendar years 1975 and 1976—from 7 percent (4 percent for public utilities) to 10 percent;² and

Corporate tax rate reductions for calendar year 1975, from 22 percent to 20 percent on the first \$25,000 of income and from 48 percent to 22 percent on the second \$25,000. The balance of income continued to be taxed at 48 percent.

In addition to the temporary features discussed above, a few permanent tax changes were enacted. The most notable were limits on percentage depletion and revisions in the tax treatment of certain foreign income. Subject to exceptions, percentage depletion was eliminated for major producers of petroleum products. For small producers, the percentage depletion rate remains at 22 percent through 1980 and then phases down to a permanent rate of 15 percent in 1985.

As indicated above, most of the changes in the Tax Reduction Act were only for calendar year 1975. However, on December 23, 1975, the Revenue Adjustment Act of 1975 (Public Law 94-164) was enacted, which effectively provided tax reductions for the first six months of calendar year 1976. For corporations, the Act extended the rate reductions that were enacted in the Tax Reduction Act of 1975. For individuals, however, larger tax reductions (at an annual rate) were enacted in order to maintain the withholding rates that applied during the last eight months of calendar year 1975.

The major provisions of the Revenue Adjustment Act as outlined in the Budget for fiscal year 1977 affecting individuals, and the amounts that would apply if the tax reductions for the first six months were in effect for a full year, are as follows:

A \$35 tax credit per exemption (except the special exemptions for the blind and aged) or an optional taxable income credit equal to 2 percent of the taxpayer's taxable income up to \$9,000, whichever is larger;

An increase in the low income allowance from \$1,300 per return to \$1,200 for a joint return and \$1,700 for a single person;

An increase in the percentage standard deduction from 15 percent of AGI with a maximum of \$2,000 to 16 percent of AGI with a maximum of \$2,800 for a joint return, or \$2,400 for a single person; and

Extension of the earned income credit that was in effect for calendar year 1975.

² This provision also applies to unincorporated businesses and, therefore, also directly affects individual income taxes.

TARGETED EXPENDITURE PROGRAMS

Although the tax cuts have provided the greater portion of discretionary policy changes in the current recession, a number of expenditure programs have been enacted and more have been proposed, aimed at offsetting the adverse impact of the recession. In addition to the regular unemployment benefits, special benefits were made available for persons not covered by unemployment insurance, and the number of weeks a person was eligible for benefits was increased to 65 from 52. Programs to provide additional jobs were also enacted. These programs fall into three general categories:

- Direct job creation;
- Public works and housing; and
- Countercyclical revenue sharing.

Table I shows the amount of budget authority, outlays and the number of jobs that these three types of programs are expected to create in fiscal year 1976 as reflected by the conference report on the Second Concurrent Budget Resolution.

TABLE I.—*Targeted Counter-cyclical Federal Expenditures*

[In billions of dollars for fiscal year 1976]

	Budget authority	Outlays	Number of jobs
Major housing legislation.....	\$5. 0	0	93, 800
Public service and manpower job crea- tion.....	3. 8	\$3. 5	428, 100
Public works.....	20. 7	3. 5	394, 100
Total.....	29. 5	7. 0	916, 000

The stimulus package as reflected in the First Concurrent Budget Resolution for FY 1976 of the House of Representatives was much stronger. The relevant totals under that package were:

Budget Authority.....	\$35.1 billion.
Outlays	13.6 billion.
Job Creation.....	1, 726, 500.

A major criticism of some counter-cyclical programs is that spending is slow and often occurs after the economy is well on its way to recovery. However, given the high levels of unemployment and the forecast length of time needed to reduce the unemployment rate, even the slowest spending programs, such as water pollution control, will probably spend out prior to a time of full employment and, thus, will not create production bottlenecks or inflationary pressures.

III. RESPONSE TO CONGRESSIONAL ACTION—THE ECONOMY IN 1975

As 1975 opened it was clear that the nation was in the grip of a harsh recession. It is now clear that by mid-year the impact of the tax cut, the growth in the regular counter-cyclical support programs, and the portent of the spending increases voted by the Congress were sufficient to stop the downward slide of the economy. A review of some of the major economic events of 1975 provides a basis for forecasting the 1976 outlook.

INVENTORIES

The volume of goods which businesses keep on hand in anticipation of sales moves up and down as buyers and sellers try to anticipate the health of the economy and the movement of prices. By late 1974, with the deepening of the recession, businessmen were faced with excessive inventories in relation to final demand. Inventories fell at a very rapid rate during the early part of 1975 and continued to decline (although at a slower rate) for most of the year. In order to reduce inventories, production was cut back and rising levels of final sales were met from already produced goods. As inventories declined and final demand continued to increase (aided by the tax rebate and rate reduction), businessmen began to reorder in anticipation of continued sales. Those replacement orders, plus some modest rebuilding of inventories, significantly aided the recovery during the summer and fall of 1975. The industrial production index increased 11.3 percent (seasonally adjusted annual rate) since the trough of the recession in April. Although some continuation of inventory accumulation is expected during the first quarter of 1976, this addition to demand will fade as the year progresses.

CONSUMPTION

By far the most significant change in the economy during 1975 was the turnaround in consumer expenditures. Real consumption expenditures dropped 2.2 percent by the end of 1974 from a peak in the third quarter of 1973. With the tax rebate and tax cut early in 1975, consumption rebounded strongly and has remained strong throughout the year. A measure of the strength which consumption expenditure increases provided the economy during 1975 is the fact that the total increase in real GNP from the fourth quarter of 1974 to the fourth quarter of 1975 was completely accounted for by increases in real personal consumption expenditures. Declining unemployment and the associated increase in wages are expected to continue to increase consumer demand during 1976, although this source of strength could diminish if other areas of the economy do not revive.

INFLATION

The double digit inflation rates of 1974 were not repeated in 1975. Rather, the rate of price increase appeared to be slowing down although the inflation rate continued well above the post WWII average. Despite Congressional action in 1975 to inject buying power into the economy through tax cuts and public spending programs, the rapid decline in effective demand which began in 1973 and 1974 forced a slowdown in production and a decline in the rate of utilization of plant and equipment. At the trough of the recession, the utilization rate fell below 70 percent of capacity—the lowest level since WWII. This slack in productive capacity forms the basis for predictions that the inflation rate will further moderate during 1976. The rise in productivity generally grows so rapidly during the early phases of economic recovery that even if unions are successful in raising wage rates by 8 to 9 percent and businesses try to recoup their lost profits the rate of inflation will probably stay in the 6 to 7 percent range during the year.

IV. THE ECONOMY IN 1976 AND 1977—THE POTENTIAL FOR STAGNATION

The recession reached bottom in April 1975, and recovery has been underway since then. A sense of continued recovery has clearly been established. Consumer spending remains strong; the inventory decline is behind us; the rate of inflation is moderating; and real economic growth, while not as strong as many would wish (5.5 to 6.5 percent during 1976), was clearly evident in the last half of 1975. The one area of immediate and continuing concern is the level of unemployment.

UNEMPLOYMENT

Although the rate of unemployment has fallen from the 8.9 percent high of May 1975 to 7.6 percent in February 1976, the level of economic growth which appears most likely for 1976 does not provide much hope for a rapidly diminishing unemployment rate. Indeed, the Administration's unemployment projection for 1976 is a dismal 7.7 percent. This projection is consistent with the widely used "rule of thumb" which suggests that a full year of growth of 4 percent in real GNP is required to maintain existing levels of unemployment and that each 1 percent of real growth in excess of 4 percent will reduce unemployment by about $\frac{1}{3}$ of 1 percent. The Administration forecasts a rate of real growth for 1976 of 6.2 percent. This prediction is consistent with forecasts made by economic forecasting firms and other business and university based economists, mainly because the Administration's fiscal policy proposals would not take effect until relatively late in the calendar year.

The depth of the recession makes it difficult to achieve satisfactory unemployment rates in the near future. If real growth in 1976 averages 6.2 percent, as forecast by the Administration, the unemployment rate is still expected to average between 7.3 to 7.7 percent for the year. If business investment does not revive toward the end of 1976, the recovery may stall. In that case, the unemployment rate would remain stable or even rise in 1977.

Not only the Administration, but virtually all private forecasters, agree that 1976 will be a year of substantial economic growth (5.5 to 6.5 percent). However, the main issue is whether significant economic progress will continue during 1977. Given the expenditure levels recommended by the Administration, economic growth in 1977 is projected to slow down. The Administration foresees a slight slowdown in 1977, while the major forecasters and business economists foresee a more substantial decline. Moreover, most of the non-Administration forecasts are based on expenditure levels providing \$10-20 billion more budget stimulus than the President's Budget, reflecting a continuation of current policy. The real differences in total output concealed by this difference in budget outlays are quite minor in terms of any effect on economic output during 1976, but very substantial in 1977.

Dr. David Grove, Vice President and Chief Economist for IBM, in his testimony before the Budget Committee highlighted this disparity. Using the Administration's budget assumptions for 1977, he predicts that real growth will be 4 percent rather than the 5.7 percent level forecast by the Administration; he also predicts an unemployment rate of 7.5 percent rather than the Administration's 6.9 percent. Wharton Econometric Forecasting Associates predicts a 3.8 percent rate of real growth and an unemployment rate of 7.4 percent, if the Administration's fiscal policy is followed. The Data Resources, Inc., econometric model produces similar results.

ALTERNATIVE FISCAL POLICIES

Alternate levels of Federal expenditures will produce different rates of economic growth and unemployment. The extent of those differences cannot be precisely determined but can be estimated. Table II shows the probable economic impact of three alternative fiscal policies.

TABLE II.—*Budget projections*

[Calendar years; in billions of dollars]

	1976 second con- current resolution	1977 official estimate	1977 alternative staff estimates		
			Presi- dent's budget (\$34.2)	Inter- mediary (\$415)	CBO's current services (\$425)
Gross National Product -----	\$1, 675	\$1, 890	\$1, 836	\$1, 893	\$1, 892
Gross National Product, 1972 dollars -----	\$1, 240	\$1, 332	\$1, 303	\$1, 331	\$1, 339
Rate of real growth (percent) -----	6. 4	5. 7	4. 2	5. 7	5. 9
Inflation rate as measured by the Consumer Price Index (percent) -----	6. 6	5. 5	5. 6	6. 0	5. 5
Unemployment rate (percent) -----	7. 4	6. 9	7. 1	6. 5	6. 6

Assumptions for 1977 alternatives:

1. House Budget Committee's staff projections for President's budget: Total expenditures of \$34,200,000,000 (unified basis) for fiscal year 1977; continuation of investment tax credit as is under Revenue Adjustment Act of 1975; reduction in the corporate income tax rate from 48 percent to 46 percent effective 3d quarter 1976; net income tax reductions of \$5,000,000,000 effective 3d quarter 1976; enactment of change in unemployment insurance tax rate from 0.5 percent to 0.65 percent and change in wage base from \$4,200 to \$6,000 effective 1st quarter 1977; enactment of increase in combined social security tax rate from 11.7 percent to 12.3 percent effective 1st quarter 1977 and an accommodating monetary policy.
2. House Budget Committee's staff current services projections: Total expenditures of \$415,000,000,000 for fiscal year 1977; enactment of change in unemployment insurance tax rate from 0.5 percent to 0.65 percent and change in wage base from \$4,200 to \$6,000 effective 1st quarter 1977 and an accommodating monetary policy.
3. Congressional Budget Office's current services projections: Total expenditures of \$425,000,000,000 for fiscal year 1977; enactment of change in unemployment insurance tax rate from 0.5 percent to 0.65 percent and change in wage base from \$4,200 to \$6,000 effective 1st quarter 1977 and an accommodating monetary policy.

For calendar year 1977, three possible budget policy alternatives could be followed. These projections reveal that there is a major inconsistency in the Administration's forecast. The receipts are consistent with the expenditure policy being proposed, but both expenditures and receipts are inconsistent with the official economic forecast. As can be seen in Table II, the staff estimates that the GNP the Presidential proposals would produce is \$1.836 billion, \$54 billion below the to \$1.890 billion, as forecast, receipts would be approximately \$10 billion higher.

The Administration projects 5.7 percent real growth in calendar year 1977. The Staff estimates of the President's expenditure and tax proposals show only a 4.2 percent real growth rate. However, this disparity in real growth does not show up in the estimates for the unemployment rate. A 1.5 percent difference in the estimates for real growth should translate into about 0.5 percent difference in the unemployment rate. The inflation estimates for calendar year 1977 show almost no change whether projected government spending for fiscal year 1977 is \$394 or \$425 billion.

Two alternate projections were made. Both assume simple extension of the existing tax cut, an increase in the unemployment tax rate and wage ceiling, and no increase in the social security tax rate. One alternative assumes unified expenditures of \$415 billion and the other, expenditures of \$425. The first alternative yields an increase in real GNP of 5.7 percent and the second an increase of 5.9 percent, rather than the 4.2 percent estimated for the President's program.

Whether 1977 will be a year of weak or strong economic growth depends not only on the levels of Federal expenditures, but also on the rate of inflation for fuel and food, on the level of private investment, and changes in state and local spending. Some of these considerations are discussed below.

FUEL

No significant change in the availability or price of oil in international markets appears likely during 1976. Neither should the United States' demand for oil products rise appreciably during 1976. The Energy Act recently signed into law mandates a price rollback on domestic oil production. However, it is not expected to affect prices for oil products during the coming year by any considerable amount since the prices charged for these products reflect an averaging process which combines domestic and foreign oil prices. The only change expected is in the average wellhead price of oil. It may decline by as much as 5 percent during 1976 (approximately $1\frac{1}{4}$ cents per gallon of gasoline), and total consumption may rise by $2\frac{1}{2}$ – $3\frac{1}{2}$ percent over 1975 levels.

Given those forecasts, production of domestic oil during 1976 is expected to remain close to 1975 levels while imports may increase by .5 to .7 million barrels a day.

FOOD

The primary difficulty in predicting food prices is the difficulty in predicting the weather. If world weather conditions are normal, food prices will likely increase at about the same rate as all other prices—6 to 8 percent. Bad weather forces up the price of food products at a rate which exceeds the general price rise. If world weather is worse than normal and grain production falls 5 percent, the overall price increase might total 8 to 11 percent. If world weather conditions are better than normal, United States' market prices might fall. These potentially lower prices could activate deficiency payments or increase loan activity for major grains.

In recent years, weather conditions have tended to reduce yields in the Soviet Union, Sub-Sahara Africa, and the United States. The effect of such production declines has been compounded further by smaller fertilizer applications in many less developed countries as a result of higher prices of petroleum—a major input to many forms

of fertilizer. With good worldwide weather conditions and larger fertilizer use expected, a serious risk of excess production could be forthcoming.

INVESTMENT—BUSINESS PLANT AND EQUIPMENT

A sustained recovery requires a substantial rise in the utilization of existing productive capacity and a subsequent increase in new plant and equipment investment. Yet, the outlook for production increases from existing capacity does not sound an optimistic note for increased business investment. Observed weakness in business plant and equipment investment is the most significant factor in forecasts which conclude that current recovery may stall and turn into another recession in 1977.

Investment in business plant and equipment (adjusted for prices) fell 15.4 percent between the spring of 1974 and the same period in 1975 and remained virtually unchanged in the fall of 1975. This situation is all the more ominous since the slack in plant utilization has been greater during this recession than in any post war period. Therefore, we have further to go before any new investment is required. Manufacturing capacity utilization fell to 67 percent at the trough of the past recession—the lowest capacity utilization rate in the post WW II period. Also utilization in the materials industries (an area of previous shortages and bottlenecks) fell to the 70 percent level. In each of the previous five post-war recessions, except 1958, business investment has increased at the same time that total output has turned up. The preliminary estimates for the fourth quarter of 1975 show a 9 percent increase in real plant and equipment expenditures. On the other hand, a recent Department of Commerce survey of business plans for new plant and equipment investment in 1976 reveals that such expenditures are expected to rise by 5½ percent during the year, less than the amount needed to cover expected price increases. Prospective spending plans all show a decline when adjusted for inflation.

INVESTMENT—HOUSING

Total private housing starts averaged about 1.4 million units per year between 1965 and 1970. Housing starts rose in 1971 to over 2 million units, and climbed again in 1972 to an all-time peak of 2.4 million units. Housing starts fell in 1973 and 1974. In 1975, total private housing starts averaged 1.16 million units—the lowest production since WWII. The 1976 outlook falls in the 1.5 to 1.6 million unit range. Although some forecasts predict a slightly higher level of housing starts in 1976 (Data Resources, Inc., predicts a 1.7 million unit level), such predictions are in the minority. Some of the factors which will critically affect housing construction during 1976 and thereby determine real growth in 1977 are construction costs, interest rates, and the cost of household operation.

Although long-term interest rates may decline somewhat during the year, present expectations are for an average mortgage rate of about 9 percent. Material costs which have increased substantially in the recent past should not rise by more than 6 to 8 percent in 1976. Wage costs may rise more than they would have if the President had

not vetoed the site construction bill.³ Therefore, wage increases in construction may exceed the predicted (8 to 9 percent) pattern of wage increases during 1976.

The demographic pressures at work in the housing market are for a faster rate of increase in household formation (1.6 million per year) during the 1970's as the baby boom comes of age.

Presently, half of the new household formations are comprised of persons under 30 years of age. The market to which that age group is attracted is low and moderately priced rental apartments. Most analysts agree that a strong surge in this most depressed area of the housing market would require an increase in rental prices above those in today's market. Although a long-term increase in single person households would tend to strengthen housing demand in this area, most analysts foresee slow improvement in multiunit construction.

An important factor limiting growth in rental construction is the poor income position of those persons most attracted to this type of housing. For instance, in 1974 (before the recession's full impact), about one-half of families headed by persons 25-32 would have been excluded from the new rental housing market, unless they were willing to pay more than 20 percent of their gross income for housing. A resurgence of demand in rental housing would, therefore, appear to be severely constrained by the poor prospects for rising employment among the population normally attracted to this market.

STATE AND LOCAL EXPENDITURES

The weaknesses noted in business plant and equipment investment plans and housing construction are primary factors in most analyses of a slowdown in real growth in 1977. A third very powerful element and one which also shows very few signs of quick recovery is the state and local government sector.

The importance of these governments in achieving vigorous and sustained economic growth is illustrated by two sets of facts. First, state and local government expenditures have nearly doubled as a percent of GNP during the last twenty years and now represent approximately 15 percent of total output. Expenditures of these units of government are likely to be a constant or decreasing share of GNP over the next several years. Second, employment in state and local government has grown very rapidly *for more than twenty years*. While Federal government employment rose by only 561,000 in the twenty years between 1955 and 1975, state and local government employment jumped 7.3 million during the same period. State and local government employment has risen by an average of 4.6 percent per year from 1960 to the present. Nearly 40 percent of state and local expenditures are for education. With the decline in the schoolage population, a continuation of that long-run trend is not expected in 1976 or 1977.

The inflation of 1973 and 1974 led local and state governments into a false sense of financial health as the initial impact of the inflation increased revenues. When the full impact of the recession manifested itself in mid-1975, revenues fell drastically and expenditures for health and welfare services mounted. These effects on state and local governments have been unevenly distributed. A survey of 48 states

³ That legislation also contained a mechanism for compulsory arbitration of certain wage disputes.

and 140 municipalities by the Joint Economic Committee found that two-thirds experienced either expenditure cuts or increased taxes. Such budget adjustments were associated with areas of high unemployment. The areas particularly hurt by the downturn were concentrated in the northeast and northcentral states. Forced cutbacks in spending have to be made in areas where employment had already been badly hit by the cyclical downturn. Cities in trouble are unfortunately located in states which are also in trouble.

Most cities are now having trouble balancing their budgets. Even where the tax bases have not declined, costs have risen from 11 to 14 percent a year while revenues have only risen 8.8 percent on the average. In some cases, capital improvement can be postponed but cities are still faced with rising wages and increasing social service costs.

The slowdown in state and local spending is likely to continue for a longer time than in other sectors of the economy. Local bond elections are being overwhelmingly disapproved as voters reject any actions that might increase their tax bill. The proportion of bond issuances approved in 1975 was 29 percent, down drastically from 62 percent the year before, and presaging further curtailment in city capital improvements.

The short-run picture is unfavorable, and there is a strong likelihood that this sector will experience a slow rate of growth through the rest of the decade. The following demographic and economic factors project a slowing in expenditure gains:

- (1) leveling of elementary and secondary school populations,
- (2) gradual leveling of state university populations.
- (3) slowing down of bond issuance for schools, universities, and hospitals,
- (4) wage growth more in line with the private sector, and
- (5) slowing in welfare increases because most eligibles have already applied.

Because of the declining expenditure factors listed above, real state and local purchases are likely to be a decreasing or constant share of the GNP.

INFLATION

Future rates of inflation depend heavily on changes in raw material prices and wage rate changes. In contrast to earlier recessions, raw material prices have not declined in the last two recessions. The price inflation in crude materials, other than food and fuel, was the result of high worldwide demand. Speculation in raw commodities is suspected to have contributed heavily to the price advances in 1974. With slackening of demand, the continued sharp increases in these prices in 1974 is difficult to explain. Because of the continued increases in wholesale prices and the attempts of groups to regain lost purchasing power discussed earlier, inflation will remain above normal (and is forecast at 6 to 7 percent) for the next year to eighteen months.

SUMMARY

The outlook for 1976 is thus for substantial growth; 1977 on the other hand may show a retreat from the growth levels of 1976. Just how serious that decline could be is difficult to determine given the uncertainties outlined previously.

V. LONG-RUN ISSUES AND POLICY OPTIONS (1978-80)

INTEGRATING FISCAL AND MONETARY POLICY

Perhaps the most critical long-run issue facing the Congress with respect to the budget process is the lack of any requirement of consistency between monetary and fiscal policy. The Congress can act to expand the economy, and the Federal Reserve can by its actions restrict or even reverse that policy determination. Any tax and expenditure program's effectiveness is dependent on monetary policies which will work in tandem with that plan.

No means is now at hand for the monetary authorities to be able to judge precisely what the Congress intends. Although the Chairman of the Federal Reserve is now providing Congress a quarterly estimate of the range of money growth to which he expects to adhere, this announcement hardly constitutes an integration of monetary and fiscal policy.

One suggestion has recently been made by Professor James Tobin of Yale University to achieve such a coordination. He would require the Congress, in its annual budget resolutions, to spell out its real growth, inflation, and unemployment targets. Upon adoption of such a resolution, the monetary authorities would be required to gear their policies to achieving the agreed upon economic objectives. Feasibility aside, there can be no doubt that there is a strong desire on the part of both the Congress and the Federal Reserve to find a means for building policy coordinated actions.

UNEMPLOYMENT

Coordination of effort between monetary and fiscal policy is vital. Unless some such integration takes place, the likelihood of achieving levels of economic growth for a period sufficient to return the nation to anything like full employment is very small indeed.

There is much uncertainty as to the long-term economic outlook. After the slowdown widely foreseen for 1977, a moderate expansion is then projected for the next few years. The consensus projection looks much like the period after the 1961 recession, when relatively full employment was not reached until four to five years later.

One forecaster, Chase Econometrics, makes an exception to the general expectations. They expect a much more rapid recovery from the current recession along with the reappearance of supply bottlenecks and rapidly escalating prices, particularly for raw materials. This scenario is expected to bring on renewed inventory speculation accompanied by a more restrictive monetary policy, resulting in a worse recession than we just experienced. This view of economic developments implies not only a very rapid economic recovery in the United States but an equally strong boom in Western Europe and Japan.

None of the major economic forecasts suggests that there is a good prospect for return to full employment by 1980. In order to keep pace with the normal growth in the civilian labor force, nearly 8½ million jobs must be created between now and the end of 1980. A 4 percent unemployment rate would require the creation of nearly 4½ million more jobs. This implies a 7 percent rate of growth in real GNP in each year after 1976. The highest average annual rate of growth we have achieved since WWII for any five year period was 5.4 percent between 1961 and 1966.

The relationship between economic growth and unemployment requires that the growth and skill level of the labor force keep pace with historical experience. In fact, although the labor force is expected to grow until 1980 at about the same rate as it did in the 1960's, it will contain relatively more younger (thus less experienced) workers, and women will have become a larger percent of the total.

The number of 21-year-olds, for instance, will increase by four million every year for the next five years. At the same time the proportion of women choosing to look for jobs is rising steadily, thereby raising job-seeking totals.

The largest increase in the labor force between now and 1980 will occur in the 25-34 age group as the post WWII baby boom grows up. This age group was approximately ⅓ of the labor force in 1970. It will account for about ¼ of the total by 1980. Job competition in this group will be severe, especially for positions with an opportunity for advancement. An economy with an unusually short supply of openings could increase the levels of dissatisfaction and frustration.

A number of long-run social trends, in addition to demographic pressures, will shape the composition of the labor force for the rest of the decade. Women continue to seek jobs outside the home in rising numbers. In 1975, they constituted 40 percent of the labor force; their participation rate has increased from 28.6 percent in 1948 at an average annual rate of 1.25 percent. The proportion of married women working is nearly equal to that for all women. Their participation rate hit 44 percent in March 1975—the highest recorded since the series began 25 years ago. In recent years, the greatest increase in the participation rate was among young women, especially mothers of preschool children, whose participation rate is now over 35 percent and is expected to rise to 50 percent by 1980.

Although the number of teenagers entering the labor force has declined from an average of 240,000 a year in the 1960's to only 70,000 a year in the 1970's, the high unemployment rate associated with this group (17+ percent during 1975) makes their future employment prospects quite uncertain.

These factors, if coupled with a national acceptance of full employment as a policy cornerstone, force a number of program issues to the surface. Some of these issues are:

(1) To what extent does a fulfillment of the commitment to full employment require (as Dr. Arthur Burns has suggested) the Federal government to become the employer of last resort?

(2) If the Federal government is not to become the employer of last resort, what improvements in existing employment and unemployment benefit programs will increase chances to attain full employment by 1980?

(3) What measures to increase the five-year economic growth rate can be enacted without threatening a return to unacceptable rates of inflation, and how much improvement will such real economic growth increases make in reducing unemployment?

INVESTMENT ADEQUACY

Capital goods refer to the goods used in the production of other goods such as plant and machinery. Over the past year there has been a number of studies done either affirming or denying the existence of a "capital shortage."

A distinction must be made between short and long-term capital needs. It makes little sense to talk about a capital shortage at a time when existing capital is under-utilized and the economy is just beginning to recover from the deepest recession since WWII. Utilization of capital dropped to 67 percent of capacity in 1975, the lowest on record (statistical series started in 1948). As mentioned earlier, one of the major uncertainties in the near-term outlook is whether capacity utilization will increase enough to stimulate the increase in investment necessary to sustain the recovery. The current projections by Data Resources, Inc. (DRI), for example, show a very slow increase in capacity utilization, averaging 74 percent in 1976 and 78 percent in 1977.

For the longer-term, a distinction must be made between a shortage of resources available to produce the capital goods needed and the inability of the financial markets to channel those resources to expanding businesses. There have been major shifts in the way corporations have financed expansion. Corporations have had to rely more heavily on external financing and debt securities (in addition to retained earnings and depreciation) to fund expansion rather than new issues of equity (stock). This shift has been encouraged by the fact that the tax laws permit the deduction of interest paid before calculating the return on capital (profits). One proposed change, suggested by Henry Wallich, would make corporate interest payments non-deductible for tax purposes and offset the increased taxes by lowering the corporate tax rate. This would eliminate the tax advantage of debt financing compared to equity financing.

In addition to this type of change, new forms of channeling savings into investment are probably needed. In the past, new financial instruments have been created as the types of funds available for investment have changed. Repurchase agreements were developed in the early 1960's to provide an outlet for short-term savings⁴; certificates of deposit were developed to assure that investable funds remain available for a specified period of time. Considerable attention should be given in the proposed reform of financial institutions to facilitating the translation of available savings into investments.

Despite the low rate of manufacturing capacity utilization and the moderate pace of the recovery, most current longer-term projections call for an increase rather than a decrease in the amount of capital required by business during the decade 1975-1985. Those projections

⁴ Repurchase agreements allow a bank or corporation to purchase United States Government securities which the government bond dealer agrees to repurchase at a set time in the future.

call for a 1 percent expansion in investment as a percent of GNP. One of the main reasons for such an increase is to provide tools for our expanding labor force. Another reason is the increased investment needed to cover the cost of pollution control.

The projected requirements for increased capital by businesses, along with concern over where the capital is to come from, have given rise to the concern over capital shortages. This concern has been increased by the size of current and prospective Federal deficits.

CROWDING OUT

The \$43.6 billion Federal deficit for fiscal year 1975, the \$75 billion deficit expected for fiscal year 1976, and the President's \$43 billion deficit projected for fiscal year 1977 have sharply increased the Federal government's demands on the credit markets. Contrary to the strong fears expressed by some Administration officials, Federal borrowing in calendar year 1975 did not "crowd out" private borrowing. Table III shows total funds raised in the United States credit markets in calendar years 1973, 1974 and 1975.

TABLE III.—*Total funds raised in U.S. credit markets*

[In billions of dollars]

	Calendar years		
	1973 (actual)	1974 (actual)	1975 (estimated)
U.S. Government	\$7. 7	\$11. 8	\$84. 2
Federal agencies	21. 6	21. 5	9. 7
State and local governments	14. 0	18. 1	16. 7
Total Government borrowing	43. 3	51. 4	110. 6
Mortgages	71. 9	54. 5	52. 8
Corporate securities	22. 1	28. 0	45. 3
Bank loans	42. 4	34. 4	—18. 6
Consumer credit	22. 9	9. 6	5. 2
All other	30. 2	34. 5	5. 9
Total private borrowing	189. 5	161. 0	90. 6
Total credit raised	232. 8	212. 4	201. 2

Government borrowing, including the unified budget deficit, off-budget agencies, government sponsored enterprises, and state and local governments rose by about \$60 billion between 1974 and 1975. Private borrowing dropped about \$70 billion. Bank loans actually declined—the first time that this has happened since the series began in 1948. This decline in private borrowing occurred as interest rates (short-term) dropped nearly 2 percentage points between December 1974 and December 1975.

The money supply (M1) ⁵ grew only 4.2 percent between December 1974 and December 1975, but (M2) ⁵ grew by 8.3 percent and (M3) ⁵ by

⁵ M1 is currency plus demand deposits. M2 is M1 plus time deposits at commercial banks other than large certificates of deposit. M3 is M2 plus deposits in non-bank thrift institutions.

11.2 percent. As the drop in the interest rates and the substantial increases in (M2) and (M3) indicate, the sharp drop in private credit raised was not the result of "crowding out" but rather the lack of demand. The lack of demand for credit was so severe in the closing weeks of 1975 and the beginning of 1976 that the Federal Reserve was unable to meet its announced target for growth in the money supply (M1). In fact, (M1) was actually declining. Large increases in Federal deficits usually occur when private credit demands slacken, although the magnitudes have been much larger than usual during this recession. The First National City Bank of New York wrote:

As it turned out, by the time the full wave [of Federal borrowing] struck in the spring quarter, private credit demand had so evaporated that lenders were quite pleased to have Mr. William Simon as a customer. . . .

(Source: Monthly Economic Letter, January 1976, Pg. 9.)

"Crowding out" like the capital shortage is not a relevant question at this stage in the economic recovery. Both could become relevant as the economy approaches full employment, as mentioned above. Internal funds (retained earnings plus depreciation) have not been sufficient to finance all business expansion.

In addition to retained earnings and depreciation, another major source of investable funds is personal savings. Between 1946 and 1969, personal savings averaged 5.9 percent of disposable (after tax) income. During the past five years, personal savings have averaged 7.4 percent of disposable income. No one knows why the savings rate has risen. However, if it remains at this level and if financial instruments are designed to channel the increased savings into business investment, the extra funds provided by personal savings would be sufficient to increase business investment from 15 to 16 percent of gross product⁶—the amount estimated to be needed to avert a future capital shortage.

If business plus personal savings are not sufficient to fund future capital needs, then additional savings would have to be provided by government savings (budget surpluses). The size of the unified deficit will automatically decline as the economy recovers. This is most clearly seen by examining the full employment balance of receipts and expenditures.

	Actual surplus or deficit	Full employment surplus or deficit
1974	-\$3. 5	+\$15. 0
1975	-43. 6	+ 5. 9
1976	-76. 0	-16. 0
1977	-43. 0	+3. 0

The Congressional Budget Office has identified an additional \$5.7 billion of expenditures automatically increased by the recession, such as food stamps and medicaid, not included in the traditional definition of the full employment calculation.⁷ Elimination of these extra ex-

⁶ This would not be true if the higher savings rate is a reflection of the relatively higher cost of housing. The payments on the principal of a mortgage are included in personal savings.

⁷ The traditional definition of full employment adjusted only for excess unemployment compensation on the revenue side.

penditures reduces the 1976 full employment deficit to just over \$10 billion and would increase the 1977 surplus to about \$8 billion.

Under President Ford's proposal, the full employment surplus would rise to nearly \$25 billion in 1978 and to almost \$100 billion by 1981. If a capital shortage does develop and if the projected amount is approximately correct (1% of GNP), then about one-third of the full employment surplus projected by the Administration in 1981 would provide sufficient funds.

However, it is not adequate to look only at the unified budget's surpluses or deficits. The off-budget agencies and government sponsored enterprises have become increasingly important in recent years. Of the \$84 billion of Federal government borrowing for calendar year 1975, shown in Table III, \$75 billion was the result of the unified budget deficit. If the borrowing for off-budget agencies is added to the other agency issues, a total of \$19 billion was borrowed in excess of the official deficit. Moreover, for fiscal year 1977, the off-budget agencies and government sponsored enterprises are expected to borrow \$26 billion in addition to the \$43 billion unified deficit.

The off-budget agencies and government sponsored enterprises are primarily credit intermediaries.⁸ The agencies borrow, either through regular Treasury issues or through Federally guaranteed agency issues, on the open market and lend to specified borrowers. Most of the programs channel funds to agriculture or housing. If a capital shortage should develop and Federal surpluses are used to generate additional savings, the existing credit allocating mechanism should be re-evaluated.

State and local governments are another source of government savings. Like the Federal government, their current receipts and expenditures are severely affected by the recession. The pension funds of the state and local governments are excluded from their operating and capital budgets. The surpluses in the pension funds have been rising gradually over time and can be expected to continue to do so. Another indirect source of government savings could come from a decline in state and local capital expenditures.⁹ With the reduction in the school age population, the need for capital expenditures for schools will be reduced at all levels.

TAX AND/OR EXPENDITURE CHANGES

Because of the progressive rate structure of the individual income tax, Federal revenues tend to grow somewhat faster than the economy. Thus, if tax rates remain unchanged for a considerable period of time, Federal revenues as a percent of GNP will rise. Expenditures also rise primarily because the law requires that many program benefits keep pace with the cost of living and because the number of people eligible for certain benefits is increasing, such as under social security. These built-in expenditure increases are not, however, as large as the automatic growth in revenues. What should be done with the growing surplus of revenues above expenditures over time depends on the

⁸ The major exception is the Post Office.

⁹ This would not be an increase in savings *per se* but rather a reduction in state and local demand for investable funds since capital expenditures are heavily financed by bond issues.

strength of private demand and decisions about the relative size of the Federal government.

If private demand, particularly investment demand, is strong, Federal surpluses (at full employment) could be used to generate additional savings to finance private investment. The surpluses would be used to reduce the Federal debt, thus making additional funds available for private investment. However, if private demand is weak, the use of Federal surpluses would increase recessionary tendencies in the economy and, in fact, would probably prevent the realization of those surpluses.

A second option is to use the growing resources to expand existing programs or to introduce new ones without increasing *tax rates*. Because Federal receipts tend to grow faster than Gross National Product (GNP), this course of action would result in a gradual increase in the Federal sector as a share of GNP.

A third option would be to grant periodic tax reductions. Such a course of action could be designed to keep the share of GNP devoted to Federal activities constant. Existing programs could be funded and even some new ones introduced but on a smaller scale than above. Some program growth is possible because a constant share of a growing GNP makes additional resources available. In general, this is the course of action that has been followed over the past twenty years. The periodic tax cuts could also be larger than those required to keep the Federal share of GNP constant. This option would provide very little room for program expansion. This is the position currently being advocated by President Ford.

The issue of how and when tax cuts should be legislated requires that the Congress make a judgment regarding how large the Federal budget should be relative to the rest of the economy. The Congress is also required to make practical judgments about the health of the economy and thus whether to restrict or expand the level of effective demand.

The use of flexible tax rates to achieve such practical ends has long been recommended. Such recommendations have generally been promoted by those who wanted to give the President authority to set tax rates, usually within a range around the permanent rate schedule. One possibility open to the Congress is to enact a tax adjustment bill each year for the following calendar year, varying the amount of tax reduction to meet the needs of the economy. Such annual re-evaluation would fit well with the new budget procedures and protect the legislature's authority over tax matters.

CONCLUSION

The deepest recession of the post WWII period reached bottom in May 1975. The severity of this recession can be illustrated by noting that even if the Administration's optimistic views were fulfilled unemployment at the end of 1976 (following some 20 months of recovery) will be as high as it has been at the bottom of any post-war recession.

Although 1976 is expected to be a year of substantial economic growth, the recovery thus far has been slow and uneven. More importantly, all economic forecasts (including that of the Administration) predict a slowing down of the economy in 1977.

Although consumer spending has provided virtually the entire support for the recovery thus far, it cannot continue to furnish such strength unless supported by a resurgence of investment. Capital spending by business firms, housing investment, and spending by state and local governments for capital projects must therefore rise for the recovery to continue past this year. The prospects for such investment are not rosy.

Capital spending would appear to be on the rise but the Commerce Department's survey of business plans for new investment would indicate that plant and equipment outlays will be less than the amount needed to cover expected price increases.

Housing starts which fell in 1975 to lowest level since WWII (1.17 million units) are predicted to total 1.5-1.6 million units, although seasonally adjusted totals of housing starts have declined each month since October 1975.

State and local governments spending has risen more rapidly than GNP during the last 20 years. For the next year or two, however, the rate of state and local spending will slow down considerably. Given the declining level of school enrollments, a leveling off of wage and welfare costs, and the pressure to slow capital spending during the current recession, real state and local purchases may in fact become a decreasing rather than increasing share of GNP.

The Administration predicts that if its budget is accepted the rate of economic growth in 1977 will be 5.7 percent. The staff estimates that given the President's budget, growth will fall to 4.3 percent (a difference of \$33 billion). If, in fact, the economy grows by only 4.0 to 4.5 percent during 1977, the unemployment rate will not continue its present downward trend, but stagnate at approximately 7.0 percent.

These estimates of real growth and unemployment are predicated on the assumption that President Ford's budget is adopted. Congress may however reject the President's proposed tax increases and decreases, extend existing tax cuts through the end of 1977, and increase outlays to levels which current policy would reflect. The staff has estimated the economic impact of such a tax and outlay (\$415 billion) budget. Real economic growth in 1977 under this simulation would rise by 1.5 percent as compared with the President's budget (5.7 percent compared with 4.2), unemployment would be about 500,000 lower, and prices would be unaffected. (The impact of a higher outlay level—\$425 billion—is outlined on p. 12 of this report.)

The longer range problems of the economy cannot however be solved within the confines of the budget decisions made in any single year. The current economic problems highlight the need for better coordination of fiscal and monetary policy, to define more adequately the practical meaning of full employment and to reflect such decisions in a series of long-range budget decisions.

SUPPLEMENTAL VIEWS OF HON. THOMAS L. ASHLEY

I am convinced that the budget proposed by the Administration for FY 1977 is inadequate to the tasks to which it is directed. The evidence of this report (like the testimony before the Task Force on Economic Projections from which the report grew) sustains that analysis.

We must construct a budget for the whole nation, not merely one for the well-off. The task is to prepare a budget which assures a recovery of sufficient strength to lower unemployment without rekindling inflation.

Business and labor economists, university based forecasters and predictions of major econometric firms are all in agreement that the President's budget will not achieve these needed results. The straightforward truth is that the President's budget is at least \$15 to \$20 billion too low to keep the recovery moving. We do not need to increase payroll taxes which will reduce workers incomes and increase inflation. We need to provide direct employment programs. We do not need to eliminate the grant-in-aid programs to the states. We need to build incentives into these programs which will improve their operation. Most importantly, we need to begin the job of planning our budgets in earnest, and that means the need to look 3 to 5 years ahead, and to allocate our dollars accordingly.

STATEMENT OF MINORITY VIEWS ON TASK FORCE PRINT SUMMARIZING FALL 1975 TESTIMONY BEFORE ECONOMIC PROJECTIONS TASK FORCE OF THE HOUSE BUDGET COMMITTEE

The foregoing statement allegedly based on testimony heard by the Economic Projections Task Force last fall and updated by the testimony of economists before the House Budget Committee last January and February is so one-sided as to scarcely merit serious consideration. Many viewpoints were heard yet the report excludes all but the ones which predict stagnation of the recovery in 1977 and hence the need for more fiscal stimulus. In the firm conviction that this species of subjective analysis of the economy can only reflect discredit on the House Budget Committee (as if the Task Force and the House Budget Committee did not hear more than one viewpoint), we will point out some of the deficiencies in the report and attempt to bring to light some of the other viewpoints heard both before the Economic Projections Task Force and before the full House Budget Committee.

It is hard to imagine reputable economists utterly ignoring the possibility that expansionary Government fiscal and monetary policies may have contributed to the unprecedented inflation rates and expectations that we have suffered since the mid-1960's. Yet the report somehow manages to ignore this possibility. Inflation instead is presented as the consequence of unique disturbances that beset our economy in the early 1970's, a 1970-73 world-wide boom, crop failures, devaluation of the dollar, and the rise in energy costs. Since these unique disturbances are unlikely to coalesce in the future, the report urges stimulative policies to bring us out of a recession that the report portrays as so deep that full employment is unlikely even by the early 1980's and to prevent what the report predicts—an almost inevitable stagnation of the economy in 1977. Thus the report is little more than a shopworn Keynesian macro-economic plea, completely innocent of the new reality—that we are presently living in a post-Keynesian world.

Our contentions may be summarized as follows: inflation is largely responsible for the recession from which we are now recovering. Inflation is largely responsible for the high unemployment rates which are now moving steadily downward with the subsidence of the inflation rate. Since the upward march of prices which began in the mid-1960's and which became dangerously rapid in 1973 and 1974 was fueled by huge increases during this period in Government spending, then additional huge increases in Government spending will worsen not improve our economy. To quote a witness whose name was mentioned in the report but whose main point was not:

Prospects for continued deceleration of inflation depend on avoiding renewed overheating of the economy. The consensus

view is that recovery will proceed at a moderate rate through this year. This will help to avoid the rekindling of inflationary pressures.¹

Stimulative fiscal policies may have a role at a time when there is a combination of high unemployment *and* declining or stable prices. However, when prices continue to rise despite slack in the economy and despite high unemployment rates, stimulative policies are inappropriate. What is required is a balanced approach that lays the foundation for a permanent improvement in the unemployment rates by dealing effectively with inflation.

A brief examination of the report will show how much has been left out.

First, the report wholly accepts the analysis by one witness of the origins of the recession—a witness incidentally who advocated more fiscal stimulus—Dr. David L. Grove, IBM Vice President and Chief Economist. Dr. Grove attributes the inflation to the sudden rise in food and fuel prices in 1973 and 1974. What this analysis overlooks is the fact that these price rises were sectoral shifts in the economy—not economy-wide changes. No attempt is made to explain how sectoral shifts became economy-wide. If such an attempt had been ventured the report might have had something to say about the role of Government fiscal and monetary policies. It depends on the nature of a given market structure whether a sectoral price increase will be passed through into the rest of the economy. Massive Governmental intervention into the market structure in the form of accommodative fiscal and monetary policies facilitates the pass-through of sectoral price increases. It is pertinent to recall here that there was an acceleration of the money supply that accompanied the Vietnam build-up. Furthermore, the wage and price controls of 1971–1974 discouraged investment, created uncertainties and bottlenecks in key industries, and led to the sharp price increases of 1974. Many firms feared that price controls would be reimposed and that they would be caught with low base prices. This fear was largely responsible for the failure of many firms to reduce the list prices of materials and industrial commodities even in the midst of the recession. Also, the report is silent about the inflationary consequences of the large-scale implementation of Government mandated environmental and safety programs. These programs also added significantly to costs and prices.

After disposing of the origins of the recession, the report suggests that congressional efforts to spend more money stopped recession and characterizes the Federal budget as “a means of allocating resources, redistributing income, and providing economic stability.” Nothing whatsoever is said of the possibility that it is precisely Governmental efforts to allocate resources, to redistribute income, and to promote economic stability that may have destabilized our economy. Not a word is said of the testimony of the Secretary of the Treasury that “if the private sector is unable to finance capital formation because of the huge demands on savings by the Federal Government and because of the resulting strains and distortions introduced in financial markets, the boom-and-recession sequence of the last decade may be repeated.”

¹ Statement of Henry C. Wallich, member, Board of Governors of the Federal Reserve System, before the House Budget Committee, February 6, 1976.

(Statement by the Honorable William E. Simon, Secretary of the Treasury, before the House Budget Committee, February 3, 1976.)

The report advocates more budget authority and outlays for public works and public service employment programs. However, the number of jobs such programs are capable of creating is considerably exaggerated. For example, a \$20 billion authority for public works, with a \$3.5 billion budget outlay in FY 1976, is supposed to generate 394,000 new jobs within a year. Based on recent BLS studies of direct and indirect manpower requirements, a \$20 billion authorization would be unlikely to outlay more than \$2 billion in 1976. For the entire program approximately 1,200,000 person years of employment would be generated of which 120,000 person years would be in 1976 and 600,000 in 1977 when outlays would be roughly \$10 billion. Similarly the report's estimates of job creation through public service employment do not take account of the significant tendency for state and local governments to use public service employment as a source of funds to finance employment which they would have offered in any case. This substitution has been shown to run as high as 90 percent.

In the third section, the report flatly contradicts one of the few witnesses that it bothered to mention and claims confidently that "even if unions are successful in raising wage rates by 8 to 9 percent and businesses try to recoup their lost profits" the rise in productivity grows so rapidly during the early phases of an economic recovery that "the rate of inflation will probably stay in the 6 to 7 percent range during the year." What the witness actually said contradicted this confident assertion:

More recently since the first half of 1975 there has been a disturbing pick-up in prices of industrial commodities at the wholesale level. From now on, further reductions in the rate of inflation will be more difficult to achieve because prices will tend to reflect unit labor costs. While increases in labor compensation moderated somewhat during 1975 to around 8 percent, they were still far above the pace of long-term productivity gains. This upward pressure on wages has been indicative of an effort to maintain real incomes in the face of still substantial price advances. Thus wages and prices continue to push each other up. (Henry C. Wallich).

The longest section of the report describes the potential in the economy for stagnation. This gloomy prediction is derived from various econometric models. However, there is no way of telling from the report itself what economic experience the models are based upon. A shift in patterns of consumer behavior different from the behaviors utilized by the models will render the models' predictions out of date. For example, many econometric models fail to utilize a very recent non-Keynesian phenomenon—consumers spending less and saving more in inflationary times. Even if the econometricians tried to take account of this, it is not clear how this all-important factor of consumer and business confidence in the health of the economy could be qualified and incorporated in a form suited to the operations of an econometric model. Indeed, "we cannot realistically expect to regain lasting prosperity until businesses and consumers see some end to the inflation

that has been damaging our economy" (Dr. Arthur F. Burns, Chairman, Board of Governors of the Federal Reserve Board).

The pitfalls the policy-maker faces in basing policy-decisions on econometric projections is amply illustrated in the report. First, the report's prediction for the unemployment rate in 1976 has already been disproven as too pessimistic by actual developments in the first quarter of 1976. Second, the econometric projections that would bear on policy decisions about how to promote real economic growth appear to be inconsistent. For example, nominal GNP is projected to increase by \$36 billion when the Administration budget of \$394 billion is replaced by a \$415 billion budget. This implies a multiplier coefficient of about 1.7. On the other hand, nominal GNP is predicted to increase by only \$3 billion when the budget outlays are assumed to rise from \$415 billion to \$425 billion, implying a multiplier of 0.3. Third, by understating the impact on inflation of increased budget spending, the report generates unjustified confidence in stimulative Federal spending. The report shows the rate of inflation remaining essentially unchanged in the face of a \$31 billion increase in budget outlays (the difference between the President's budget and the CBO Current Services budget). Higher budgetary outlays can easily rekindle inflationary expectations even when there is excess capacity; and such inflationary expectations may not be captured by model simulations which are based largely on past data and past relationships. Fourth, it is not at all clear what the report means by monetary accommodation, yet the policy-maker needs to know this. "Monetary accommodation" is assumed to prevail under the three alternative outlays simulations in Table II. Yet, the term is not defined. Monetary accommodations may mean different things to different people. If by accommodation one means the adoption by the Fed of a sufficiently expansionary monetary policy that will accommodate higher Government spending and prevent short-term interest rates from rising (which is how Data Resources Inc., defines the term), then the GNP multipliers associated with the increases in Federal outlays from the Administration's \$394 billion budget to the \$415 billion and the \$425 billion budgets should be higher than those implied by Table II of the report. This is because some econometric models, especially DRI, are highly responsive to monetary policy changes. The report does not point out that there is a trade-off between fiscal and monetary policies and that the economic effect of lower Fed spending could be offset by a more expansionary monetary policy.

People can see farther ahead than their noses and this applies to consumers and businessmen too. Thus, the expectations of consumers and businessmen of future inflation clearly affect their decisions to buy and invest. The fact that the inflation rate has been slowed helps account for the upsurge in consumer purchasing. If this confidence is sustained we may expect greater attempts at capital formation, especially in 1977. But the key factor is sustaining consumer and business confidence that the economy is under control. In advocating more stimulus the report undermines confidence. If applied, more stimulus might well undermine the recovery and lay the groundwork for massive unemployment.

Thus, the gloomy predictions of the report are based on a misunderstanding of an absolutely crucial human factor—confidence that the Government will restrain inflation rates by restraining its own deficit

spending. "The main task of over-all fiscal policy in promoting and protecting a sustainable recovery, under the circumstances, is to bring down the massive current Federal deficit." (Henry Wallich). A very different analysis might have emerged if the report had chosen to consider this viewpoint which was ably articulated both before the Economic Projections Task Force and before the full House Budget Committee. For example, the report might have concluded differently about the outlook for business fixed investment and capacity utilization.

The report is pessimistic about the outlook for business fixed investment, which is one reason for its assessment that real output growth in 1977 will be very modest. Its conclusions are based on recent plant and equipment surveys that show little or no real growth in business fixed outlays this year and the presence of unused productive capacity of more than 25 percent.

One should not take equipment surveys at face value. That is because planned capital outlays are subject to periodical changes in light of new information about costs, prices, and sales. By and large, these investment plans tend to be unduly optimistic during periods that immediately precede downturns in economic activity, largely because firms are influenced by prevailing economic conditions that seem deceptively favorable. But once a recession is well underway, previously planned investment projects are either trimmed or postponed. On the other hand, planned capital outlays are normally bearish during the early phases of business recoveries because business firms are not always convinced that a solid recovery is in process. As soon as the uncertainties regarding the vigor of economic expansion are removed (which is what seems to be happening now), firms generally respond by augmenting their plant and equipment investment. Over the next 2 years, business investment should be helped by the recent significant improvement in business liquidity position and by the bright prospect for corporate profits, *provided* acceptable fiscal and monetary policies are followed.

Regarding capacity utilization, some economists contend that some of the existing capital stocks may have become obsolete by the recent high cost of energy and related inputs. If this is the case, published capacity utilization rates are deceptive to that extent, and many industries may undertake major modernization plans to remain competitive. And here the report might have considered the work of another witness, Dr. Tilford C. Gaines, Senior Vice President and Economist, Manufacturers Hanover Trust Co., who raises some serious questions about the measures of capacity utilization so confidently relied upon in the report.

The report touches on the difficulties of achieving a 4-percent unemployment rate within the next 4 to 5 years but devotes little attention to the need to provide economic incentives for achieving a higher rate of capital formation. According to a recent study by the Bureau of Economic Analysis of the U.S. Department of Commerce, the share of real business fixed investment in the Nation's total output of goods and services may have to be increased from the current rate of about 10 percent to as much as 12 percent over the next 4 years in order to achieve the goals of full employment, greater energy independence and pollution abatement. This could be accomplished by

pursuing public policies that would: (a) reduce the rate of growth of Federal spending and move toward a position of budgetary balance; and (b) revising tax laws so as to insure higher after tax returns on investment projects. It is noteworthy in this connection that the report offered reassurances that the problem of "crowding out" has been exaggerated. These reassurances were exhaustively considered by the Secretary of the Treasury and rejected. He testified that in the next decade the need for capital formation is extremely large and that we may well face a serious "crowding out" problem in the future if deficits remain high. Yet the Honorable William E. Simon's testimony is not even mentioned.

In conclusion, this sort of one-sided report helps no one, not even the advocates of more stimulus, for no one can respect conclusions arrived at by consistently ignoring embarrassing evidence and opposing arguments.

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